



U.S. Department of Agriculture



Office of Inspector General
Midwest Region

Audit Report

Rural Housing Service Controls over Single Family Housing Grants and Loans

Report No. 04601-0016-Ch
September 2007



UNITED STATES DEPARTMENT OF AGRICULTURE

OFFICE OF INSPECTOR GENERAL

Washington, D.C. 20250



SEP 25 2007

REPLY TO

ATTN OF: 04601-0016-Ch

TO: Russell T. Davis
Administrator
Rural Housing Service

THROUGH: John Purcell
Director
Financial Management Division

FROM: Robert W. Young /s/
Assistant Inspector General
for Audit

SUBJECT: Controls over Single Family Housing Grants and Loans

This report presents the results of our audit of the Single Family Housing (SFH) Program direct loan and grant activities at the Carthage, Illinois, local office. Your agency's response to the official draft report is included in its entirety as exhibit B, with excerpts and the Office of Inspector General's position incorporated into the relevant sections of the report.

We performed the audit at the request of the Illinois Rural Development State officials who suspected that a former employee had submitted false documentation related to paid off loans subject to subsidy recapture. Our audit focused on the activities of the former employee to include loan payoff and subsidy recapture procedures, as well as loan and grant origination procedures at the local office. We also examined Rural Development loan and grant files, Centralized Servicing Center (CSC) subsidy recapture documents, and documents from third parties such as title companies, financial institutions, law firms, and appraisers. We performed our audit in coordination with the Office of Inspector General, Investigations.

Our audit identified three instances where the former employee provided fictitious documents to CSC for use in calculating subsidy recapture. These instances were in addition to three other cases found by Rural Development officials in Illinois. The six cases resulted in a loss or unestablished accounts receivable of \$12,445 in subsidy recapture to the Government. (See exhibit A.) We did not find any indications of fraud in the loan or grant origination areas.

BACKGROUND

Rural Development, through RHS, administers the SFH Program, which offers loans and grants to low and moderate-income individuals to buy, build, repair, and improve homes. Rural Development State and local offices are responsible for issuing direct loans to borrowers. Many borrowers receive subsidies that are subject to recapture when they refinance, sell, or cease to occupy their properties. The amount of subsidy to be recaptured is based, in part, on property appreciation. The appreciated value of a property is based on the current market value of the property at the time of payoff, which is determined using either a signed sales contract or an appraisal.

The CSC calculates payoff amounts and determines the amount of subsidy to be recaptured for all loans made by Rural Development. The subsidy is to be paid when the borrower vacates the property, such as when it is sold. When the borrower remains in the property, such as when a loan is refinanced by an outside lender, subsidy recapture is calculated and Rural Development establishes a subsidy accounts receivable with a corresponding lien on the property. The receivable is due when the borrower vacates the property. As an incentive to pay the subsidy recapture amount earlier, borrowers eligible to defer the recapture amount will receive a twenty-five percent discount if it is paid upon refinancing or within 60 days of the final loan payment.

In March 2006, the Carthage, Illinois, local office supervisor notified State officials of suspicious activity of an agency employee related to loan payoffs and subsidy recapture. The State officials questioned the employee, reviewed files, and found three instances where the former employee submitted false information to CSC. The State alerted CSC officials for two cases that had not yet been paid off. They also obtained independent appraisals for those two properties, which showed the actual current market value of the properties. These amounts were used to calculate subsidy recapture, rather than the fictitious amounts provided earlier by the former employee. The State officials' actions for these two cases saved the Government \$2,610 in interest subsidy that otherwise would not have been recaptured from the borrowers. For the third instance, the borrower had already paid off the loan. Based on an actual sales contract obtained by State officials, this borrower should have repaid \$496 in subsidy to Rural Development.

On April 17, 2006, the Illinois Rural Development State Office requested that we review the direct loan payoff activities in the Carthage, Illinois, local office. The Carthage, Illinois, local office was a two-person office. The former employee was responsible for direct loan and grant origination, and for submitting payoff requests to CSC to determine subsidy recapture.¹ The other employee was responsible for guaranteed loans. The fraudulent payoff documents were found by the other employee, after CSC officials requested an appraisal for a suspicious pending payoff quote on a day when the former employee was out of the office.

¹ Direct loan and grant origination entails reviewing completed applications; verifying that applicants meet income limits, citizenship requirements, and age limits when applicable; ensuring that applicants have the ability to make payments; and determining if borrowers initially qualify for payment assistance.

OBJECTIVES

To determine if a former agency employee had created fictitious loans and grants, and had committed fraudulent acts in determining the amount of subsidy to recapture from borrowers. In the process of making these determinations, we also evaluated the Rural Development's internal controls in these areas.

SCOPE AND METHODOLOGY

We performed our audit work at the Rural Development State Office in Champaign, Illinois, and at the Quincy, Illinois, local office. (The Carthage, Illinois, local office was in the process of being consolidated with the Quincy, Illinois, local office.) We interviewed agency officials at the RHS National Office, the Illinois Rural Development State Office, the Quincy and Carthage, Illinois, Rural Development local offices, and at the CSC, to identify procedures and internal controls related to loan payoffs and subsidy recapture, as well as loan and grant origination. We assessed those controls to determine the cause of questionable activities involving the former employee.

We accompanied a criminal investigator during interviews with the former employee and four former Rural Development borrowers. We issued subpoenas to three financial institutions to obtain appraisal information for three former Rural Development borrowers' properties. We conducted our fieldwork from July to November 2006, in accordance with *Government Auditing Standards*.

We reviewed records related to all 32 loans for 27 borrowers that were paid off between October 2004 and March 2006. These loans totaled over \$1 million. We also reviewed 6 loans, for 5 borrowers, which were paid off prior to October 2004.² These were all the loans available for review for the period prior to October 2004. They were only available because they had outstanding recapture amounts due. (Documents are typically destroyed one fiscal year after loans are closed and paid off.) We obtained recapture calculation documents from CSC for the 32 borrowers to determine the values used in calculating subsidy recapture. We also obtained documents such as appraisals, sales contracts, and settlement statements from third parties such as appraisers, financial institutions, law firms, or title companies.

From October 1, 2004, until April 1, 2006, the Carthage, Illinois, local office issued 37 loans totaling over \$2.2 million; 32 repair loans totaling over \$123,000; and 16 repair grants totaling over \$65,000. We selected 28 of the 37 loans, totaling over \$1.7 million, for review based on the date the loan was made. Our review included all 48 repair loans and grants issued during our review period. We verified that all of these borrowers and grantees existed, and determined if any were related to the former employee.

² The borrowers paid off their loans between November 1999 and June 2004.

To accomplish our audit objectives, we reviewed the following items:

- the CSC Payoff Procedure Manual;
- agency regulations, program procedures, and handbooks;
- prior Office of Inspector General audit reports; and
- mortgage and real estate information on file at the Hancock County Courthouse.

FINDING

Payoff Procedure Weakness Created Opportunity for Fraud

A former employee provided CSC officials with fictitious documents for six borrowers (three uncovered by Rural Development and three by the Office of Inspector General [OIG]) at the time the loans were being paid off, between December 2004 and June 2005. The former employee was able to submit false documents because there were too few employees to adequately separate duties at the local office. There was also no second party review performed of the documents submitted to CSC. Further, CSC generally does not verify the legitimacy of payoff documents submitted by field officials. As a result, the Government lost \$12,445 in uncollected subsidy recapture (\$11,949 found by our audit, where an accounts receivable would have been established and \$496 identified by Rural Development officials, which would have been collected at closing).

For the three instances disclosed by OIG, the former employee submitted fictitious sales documents to CSC. We found, the selling price recorded on the documents was low enough where borrowers would not have to repay subsidy. We determined the actual amount that should have been used from original appraisals and settlement statements obtained from the financial institutions that refinanced the borrowers' loans. Subsequently, we requested that CSC recalculate the amount of subsidy that would have been established as a recapture receivable from these three borrowers. Based on CSC's calculations, we determined that Rural Development would have established a subsidy accounts receivable for \$11,949 from the three former borrowers identified by our audit.

During initial questioning, the former employee admitted to creating fictitious sales contracts and settlement statements for two of the improper loan payoffs uncovered by State officials, but maintained that the documents were submitted to CSC for the purpose of calculating hypothetical payoff quotes. To determine the validity of this statement, we questioned CSC officials who refuted the former employee's comments. CSC officials stated that they use final documents submitted by field staff to calculate the final loan payoff amount and the amount of subsidy to recapture from borrowers. Thus, there should never be instances where documents are submitted for hypothetical purposes.

The former employee stated that the two admitted instances uncovered by State officials were the only cases where false documents were submitted to CSC. However, we found another three instances that indicated the former employee had submitted false documents to CSC. Consequently, we interviewed those three former borrowers, and the remaining borrower uncovered during Rural Development's

review. Three borrowers confirmed that the documents submitted to CSC on their behalf were false and they had no prior knowledge of those documents. One borrower was unsure, and could not confirm if the documents were false.

After meeting with the four former borrowers, we confronted the former employee with letters that individual had sent to CSC stating that the borrowers were selling their properties along with the former borrowers' statements. The former employee admitted to submitting false information to CSC for three of the borrowers. Again, the former employee maintained that the false information was submitted to obtain a written hypothetical payoff calculation for the borrowers.

The former employee denied submitting the falsified information to prevent the borrowers from having to repay subsidy. Also, the former employee claimed to be unaware of CSC's position that it does not provide written hypothetical quotes. The former employee did offer to repay the amount of subsidy not recaptured or established as a receivable due to those actions. Rural Development would have collected or established a receivable for \$5,659³ in recaptured subsidy from these three borrowers had the proper documents been submitted to CSC.

For the fourth borrower, the former employee stated that the borrower planned to sell the property for the amount presented on an option to purchase. Thus, that document was submitted to CSC to obtain loan payoff amounts. However, according to CSC officials this document should not have been submitted until the property was actually sold. Since the subpoenaed documents indicated that the borrower refinanced and did not sell the property, the option to purchase should not have been submitted to CSC. Additionally, the appraisal used by the financial institution listed the property's value at \$78,000; \$25,000 more than the selling price on the option to purchase used by CSC. This resulted in a loss of \$6,786 in uncollected subsidy recapture or unestablished subsidy receivable. Based on the significant difference between the two documents, and the former employees' admission that other similar documents were falsified, it is our view that this instance involved fictitious documents.

The CSC payoff manual states that either a signed sales contract or an appraisal needs to accompany the payoff request to show the current market value of the property. There is no requirement to verify the legitimacy of payoff documents. Thus, false documents submitted by borrowers or field staff would go undetected by CSC staff. However, the risk of abuse is mitigated in most cases because payoff documents are generally submitted by third parties such as realtors, settlement agents, and financial institutions.

The former employee was also able to submit false documents because only one person was responsible for submitting payoff documents to CSC to be used to calculate payoff and subsidy recapture. The Government Accountability Office *Standards for Internal Control in the Federal Government* states that segregation of duties is a control activity key to reducing the risk of fraud.⁴ However, because this local office was staffed by only two employees, the separation of duties was difficult to implement. Thus, to prevent future incidents of abuse, Rural Development should require

³ This amount includes the \$496 found by Rural Development officials during their review of the former employee's activities.

⁴ GAO *Standards for Internal Control in the Federal Government* – November 1999

that all payoff documents be sent directly from third parties to CSC, as opposed to being sent through the local office or from the borrowers.

Recommendation 1

Require all payoff documents be provided to CSC by independent third parties such as title companies, financial institutions, and appraisers.

Agency Response

RHS officials did not agree with this recommendation. They disagreed for the reasons cited in their attached response. The main reasons cited were as follows: (1) the incident was an isolated case; (2) it would eliminate field office oversight of the process; and (3) the cost and negative impact of our recommendation would outweigh the benefits to RHS and the public. As an alternative, agency officials proposed that payoff information submitted to CSC by local offices be reviewed and initialed by a second employee.

OIG Position

We cannot agree to a management decision at this time. We can accept the proposed corrective action when Rural Development officials agree to incorporate second party review procedures into their operating manual, and provide a timeframe for completing this action.

Regarding the context of the response, we are compelled to reply to several specific statements. The agency response began with a statement that our recommendation is too costly to implement and eliminates field office oversight. However, it is our understanding that most field offices are currently using the same procedure suggested by our recommendation. In fact, we were told that the field office involved in this audit was one of the few offices around the country that do not follow the procedure recommended in our audit. We do not understand how the cost of implementing a procedure already being used throughout the country would outweigh the benefits derived from that procedure. We are simply recommending that the procedure used by most field offices be implemented for all field offices.

In regards to this being an isolated incident, our review, as required by *Government Auditing Standards*, included an examination to assess the adequacy and effectiveness of management controls in this area agency-wide. We accomplished that through an analysis of agency procedures in effect for all field offices and through many discussions with local, State, and national officials. The fact that we tested the management controls at only one office does not detract from our conclusion that a systemic weakness exists in the procedures followed by other field offices using the same procedures. In fact, agency officials' statement that this is an isolated incident cannot be supported because the systemic weakness indicates that it could be occurring in other offices. However, there are no management controls to either prevent it from occurring or to detect it if it does occur.

We also disagree with the agency's reluctance to place reliance on third parties and that our recommendation conflicts with the first priority of the President's Management Reform Initiative. As stated earlier, many field offices have already implemented the procedure addressed in our recommendation. Thus, the procedure used at most agency field offices would also conflict with the President's Initiative.

Recommendation 2

Require the former employee to repay the \$12,445 of subsidy not recaptured, or established as an accounts receivable, from borrowers cited in this report.

Agency Response

The former employee is currently repaying the lost amount.

OIG Position

We accept management decision for this recommendation. Final action can be reached when RHS provides OCFO with documentation of an established accounts receivable with the former employee.

Exhibit A – Summary of Monetary Results

Exhibit A – Page 1 of 1

| Finding Number | Description | Amount | Category |
|-----------------------|---|---------------|---------------------------------------|
| 1 | Subsidy not recaptured from paid-off loans, or established as an accounts receivable, due to the submission of false documents. | \$12,445 | Questioned Cost, Recovery Recommended |
| TOTAL | | \$12,445 | |

Exhibit B — Agency Response

Exhibit B — Page 1 of 5



United States Department of Agriculture
Rural Development

SEP 06 2007

SUBJECT: Housing and Community Facilities Programs
Official Draft - Rural Housing Service
Controls over Single Family Housing Grants
and Loans - (Audit No. 04601-016-CH)

TO: Robert Young
Assistant Inspector General
for Audit

Attached for your review is a revised response dated August 31, 2007, from David J. Villano, Deputy Administrator, Single Family Housing, concerning Recommendations 1 and 2 in the above subject audit.

This response is being submitted to reach management decision on Recommendations 1 and 2 of the audit report.

If you have any questions, please contact Arlene Pitter of my staff at (202) 692-0083.

A handwritten signature in cursive script, reading "John M. Purcell".

JOHN M. PURCELL
Director
Financial Management Division

Attachment

1400 Independence Ave. SW • Washington, DC 20250-0700
Web: <http://www.rurdev.usda.gov>

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Exhibit B — Agency Response

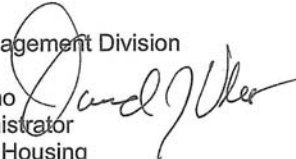
Exhibit B – Page 2 of 5



United States Department of Agriculture
Rural Development

AUG 31 2007

TO: John Purcell
Director
Financial Management Division

FROM: David J. Villano 
Deputy Administrator
Single Family Housing

SUBJECT: Office of Inspector General (OIG) Audit No. 04601-016-CH
Controls over Single Family Housing (SFH) Grants and Loans

Attached please find a "revised" response to the subject Audit Report.

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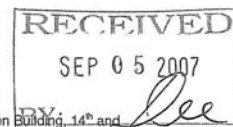


Exhibit B – Agency Response

Exhibit B – Page 3 of 5



United States Department of Agriculture
Rural Development

AUG 31 2007

TO: John Purcell
Director
Financial Management Division

FROM: David J. Villano *David J. Villano*
Deputy Administrator
Single Family Housing

THROUGH: Russell T. Davis *Russell T. Davis*
Administrator
Housing and Community Facilities Programs

SUBJECT: Office of Inspector General (OIG) Audit No. 04601-016-CH
Controls over Single Family Housing (SFH) Grants and Loans

We appreciate the opportunity to provide comments to the subject Audit Report.

The Audit was conducted in response to an issue discovered by Rural Development surrounding the actions of an employee who submitted false documentation related to paid off SFH loans subject to recapture. OIG investigated the employee's activity and local office loan/grant origination procedures, Centralized Servicing Center (CSC) recapture records and procedures, and other documents.

We appreciate the thorough effort of OIG in response to Rural Development's request to investigate this case of employee misconduct. This effort ensures the integrity of the SFH program by protecting employees from lack of trust and the public from misuse of tax dollars.

We provide the following responses to the OIG recommendations:

Finding: Payoff Procedure Weakness Created Opportunity for Fraud

Recommendation 1 – Require all payoff documents be provided to CSC by independent third parties such as title companies, financial institutions, and appraisers.

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RHS Response – Do Not Agree

The cost and impact of the OIG recommended cure far outweigh the benefits to RHS and the public. The subject OIG report identified \$12,445 of loss from fraud. This represents .0068 percent of the more than \$181 million of the subsidy recapture collected by Rural Development in FY 2006. Nothing in the OIG report suggests fraud of this type is widespread or likely to increase. Briefly, this is an isolated incident.

While the dollar cost to the government to implement this OIG recommendation may be minimal, the recommendation if instituted could delay sales of some borrowers' homes by creating unnecessary, stringent guidelines upon third parties unfamiliar with recapture and SFH payoff requirements.

OIG's recommendation will eliminate the option of working with local staff, reducing the level of personal service to the rural families we serve. It conflicts with the first priority of the President's management reform initiative to make government "citizen-centered" – more accessible and responsive with reduced distance from citizens. It mandates reliance on local title company staff, private loan originators, and appraisers, all unfamiliar with the unique recapture calculation. These parties, often have a direct interest in the payoff. It would be left unchecked by local staff, increasing the probability of fraud and error.

This is a highly unusual case in that it appears the employee committed fraud yet did not personally benefit from these actions. Apparently, the actions were taken as a favor to the borrowers because the employee did not believe in the concept of subsidy recapture. To the best of our knowledge, no similar case of employee misconduct has occurred.

While many payoffs are presently conducted as recommended, eliminating the option of the local Field Office is unnecessary and reduces service to the public. Again, this is an isolated case. The corrective action recommended does not appear consistent with the best interests of our program or customers. As an alternative to meet the OIG concern on the separation of duties, any information for payoff calculations submitted by the local office to CSC could be reviewed and initialed by a second employee.

Exhibit B – Agency Response

Exhibit B – Page 5 of 5

3

Recommendation 2 – Require the former employee to repay the \$12,445 of subsidy not recaptured, or established as an accounts receivable, from borrowers cited in this report.

RHS Response – Agree

The former employee is currently repaying the lost amount in installments. Recovery can be made from any retirement or other Federal benefits to which the employee may be entitled.

We request this response be made part of the final OIG report. If our responses are not accepted by OIG, we also request the OIG officials to schedule a joint meeting between OIG officials, RHS officials, and the Under Secretary for Rural Development who has been briefed on the subject audit and this response.

Informational copies of this report have been distributed to:

| | |
|--|---|
| Administrator, Rural Housing Service, | |
| Through: Director, Financial Management Division | |
| Operations and Management | 4 |
| U.S. Government Accountability Office | 1 |
| Office of the Chief Financial Officer | |
| Director, Planning and Accountability Division | 1 |